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INVESTOR INSIGHTS – FOURTH QUARTER 2020

Why having a Framework and Principles is Critical for Investment Success

When you compare the difference between the damage our shutdown has done to our economy and the damage it has done to our market indices, the contrast is dramatic. The two are as disconnected as we have ever seen them. Q2 GDP was negative 32% after being negative 5% in Q1, yet the stock market is hitting new highs.

Now it is understandable that the damage to the economy happened as we shut down our economy to slow the growth of COVID-19. The impact has been that many sectors have been devastated while a few others expanded. We are not flying, going to restaurants, or staying in hotels the way but used to do, but we are having Zoom meetings at 30 times the pace of January. We cannot go to movies, but we are watching Netflix instead. We could not go to retail stores, so Amazon saw an increase in volume.

We see the S&P 500 getting back into positive territory, and we have been asking ourselves why this disconnect exists. If GDP is down as much as it is, why have stock market indices rebounded? Are they telling us everything will be fine? Are they telling us that all those people who have lost their jobs will get them back? Our answer to these questions comes from a review of history. What we know is there was never a time when stock prices did not reconnect to reality, and the stock market indices today are telling us this time is different. What we know from history is there has never been a time when this time was different.

So, let us look at the S&P 500 and see what is really going on. Table 1 shows the top five names of the index plus Netflix, their percent weighting in the index, their return for the year and their contribution to the total return of the index.

Table 1

Name	Weight	YTD 8/31/20	Contribution
Apple Inc	7.00	78.28	5.48
Microsoft Corp	5.98	44.25	2.64
Amazon.com Inc	4.91	86.85	4.26
Alphabet Inc (Google)	3.35	21.63	2.14
Facebook Inc	2.43	43.44	1.06
Top 5 Subtotal	23.67		15.58
Netflix Inc (21st largest)	0.79	63.79	0.51
Subtotal	24.46		16.09
S&P 500		9.74	

It turns out the market is not up, just the index and a handful of stocks. This analysis shows us that the top five stocks in the index plus Netflix are up 16.09% year to date as weighted from the index, and the total index is up only 9.74%. Said differently, these six stocks are up 16.09% while the S&P 494 is down 6.35%, and the value

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part of the investing equation is worse. So, I know we have all seen this and read about the concentration of stocks that have brought the market up with them, but conventional wisdom is telling us these companies are thought to be disruptive technology companies and they can continue to rise. Our view is not so fast. The first part is true, they are disruptive technology companies, but we do not think they can continue to rise. They have all reached some level of maturity and are trading at absurd prices. Let us look at Netflix as an example. It is thought that Netflix benefitted from all of us staying at home. We were not going to movies, so we were watching Netflix movies. That is true. The problem was the increase in sales that Netflix experienced did not come with corresponding earnings increases. In Q1, Netflix missed earnings estimates by 7 cents and in Q2 by 22 cents. Why? Because they had to ramp up to take on the new customers. What is happening now with Netflix? They are losing customers who have lost their jobs. In an effort to keep this newsletter at a reasonable length, we will not analyze the other companies, but you would see a variation of the same phenomenon. The other issue with this group of stocks has to do with their price. Netflix trades at a 93 P/E and 10.47 times sales. Both suggest a price that cannot be sustained.

Who pushes up the price? There are two groups: interest rates are low so some investors switch to stocks and there are lot of FOMO (aka Fear of Missing Out) investors. The argument is that bonds have yields below 2% so investors need to invest in stocks. Even if we agreed with that logic, we would not agree that the FAAAM stocks and Netflix are the right stocks. Our dividend portfolios yield over 4%, have lower vol and have outperformed the indices over time. We would ask why not them? The fear of missing out is also prevalent today. We see the rise of Robin Hood, as well as investors, without a plan or objectives other than being invested in what is going up. That is not a strategy, it is gambling, and it has always ended poorly with lots of losses.

Our friend, Mark Grant, wrote a piece last week that grabbed our eye. He compared what is happening in the markets to conversations between Alice and the Cheshire Cat from Alice in Wonderland by Lewis Carroll.

‘Would you tell me, please, which way I ought to go from here?' asked Alice.

'That depends a good deal on where you want to get to,' said the Cat.

'I don't much care where -' said Alice.

'Then it doesn't matter which way you go,' said the Cat.

'- so long as I get somewhere,' Alice added as an explanation.

'Oh, you're sure to do that,' said the Cat, 'if you only walk long enough.”

This sounds to us exactly what index investors are doing, not sure where they are going but they are getting there. The question is: will they know where they are when they get there, or will they just be on a roller coaster like other periods of concentration?

We know where we are going: we are depending on income from dividends to drive us there and disruptive technology stocks that will change the world. None of these stocks are in our disruptive technology portfolio. Alice had something to say about advice. We think index investors are following Alice, but even she sees her flaw. You wonder when these investors will learn from her logic.

‘I give myself good advice, but I seldom follow it.’ – Alice.

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